

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B03

PLR-135409-08

Date:

February 13, 2009

## LEGEND

Company =

Shareholder =

Beneficiary =

Trust1 =

Trust2 =

State =  
Date1 =  
Date2 =  
Date3 =  
Date4 =  
Date5 =  
Date6 =  
Year1 =  
Year2 =  
Year3 =  
Dear :

We received your letter dated August 13, 2008, and subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code. This letter responds to your request.

### **FACTS**

Company began operations on Date1. Company filed articles of incorporation in State on Date2. Upon formation, Company filed Form 2553, Election by a Small Business Corporation, to be treated as a subchapter S corporation effective Date1. From Date1 to Date4, Shareholder was Company's sole shareholder.

Beginning on Date3, Company made advances to Shareholder on an as needed basis. Shareholder used the advances for personal purposes and the advances were not embodied in a written promissory note. However, on Date6, Shareholder and Company executed a Credit Agreement and Promissory Note evidencing their intent that the advances constitute debt. In Year2, all of Company's shareholders and directors approved the Credit Agreement and Promissory Note. Shareholder and Company represent that all advances were intended to constitute debt and were

expected to be repaid with interest. Company also represents that, under Company's articles of incorporation, by-laws, and State law, all of the issued and outstanding shares of capital stock of Company have identical rights to distribution and liquidation proceeds, and that Company has never had any written or oral agreement, or any other type of understanding, with any shareholder that would entitle any shareholder to preference regarding distribution and liquidation proceeds.

On Date4, shares of Company stock were transferred to Trust1. Company represents the Trust1 is qualified to be treated as an electing small business trust (ESBT). However, trustee of Trust1 failed to file timely the ESBT election. In addition, Trust1 improperly treated itself as though it were a qualified subchapter S trust (QSST).

On Date5, shares of Company stock were transferred to Trust2. Company represents the Trust2 qualifies as a QSST and has been treated as though a timely QSST election had been made. However, trustee of Trust2 failed to file timely the QSST election.

Company represents that the circumstances resulting in the termination of the S corporation election were not motivated by tax avoidance or retroactive tax planning. Company further represents that Company has filed federal income tax returns consistent with the treatment of Company as an S corporation at all times since Date1. Finally, Company and each of Company's shareholders agree to make any adjustments required by the Secretary consistent with the treatment of Company as an S corporation.

## **LAW AND ANALYSIS**

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible shareholder and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(c)(2)(A)(v) provides that for purposes of § 1361(b)(1)(B), an ESBT is a permissible shareholder.

Section 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2), (A) such trust shall be treated as a trust described in § 1361(c)(2)(A)(i); (B) for purposes of § 678(a), the beneficiary of such

trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made; and (C) for purposes of applying §§ 465 and 469 to the beneficiary of the trust, the disposition of the S corporation stock by the trust shall be treated as a disposition by such beneficiary.

Section 1361(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1361(d)(3) provides that for purposes of § 1361(d), the term “qualified subchapter S trust” means a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary; and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States. A substantially separate and independent share of a trust within the meaning of § 663(c) shall be treated as a separate trust for purposes of §§ 1361(d) and 1361(c).

Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(B), the term “electing small business trust” means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2)-(5), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust.

Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the QSST election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1.1361-1(l)(1) provides that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1<sup>st</sup> day of the 1<sup>st</sup> taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

### CONCLUSION

Based solely on the facts submitted and representations made, we conclude that if Company had more than one class of stock, Company's election to be treated as an S corporation terminated on Date3 when Company first made advances to Shareholder. We also conclude that when Company transferred shares to Trust1 on Date4 and shares to Trust2 on Date5, Company's S election would have been terminated because Trust1 failed to file timely an ESBT election under § 1361(e)(3) and Trust2 failed to file timely a QSST election under § 1361(d). We further conclude that the termination was inadvertent within the meaning of § 1362(f). Consequently, we conclude that Company will continue to be treated as an S corporation from Date1 and thereafter, provided that Company's S corporation election was valid and was not otherwise terminated.

Additionally, we conclude that Trust1 will be treated as an ESBT from Date4 and thereafter, provided trustee of Trust1 files an ESBT election for Trust1 with the appropriate service center, effective Date4, within 60 days of the date of this letter. Trust2 will be treated as a QSST from Date5 and thereafter, provided trustee of Trust2 files a QSST election for Trust2 with the appropriate service center, effective Date5, within 60 days of the date of this letter.

This ruling is contingent on Company and all of its shareholders treating Company as having been an S corporation for the period beginning on Date1, and thereafter. The shareholders of Company must include their pro rata share of the separately stated and nonseparately computed items of Company as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by Company as provided in § 1368. In addition the Year1, Year2, and Year3, income tax returns of Beneficiary and Trust1 must be amended as necessary to properly reflect Trust1's status as an ESBT.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

If all of the above conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, Company must notify the Ogden Service Center that its S corporation election has terminated.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion regarding whether Company is otherwise eligible to be treated as an S corporation or whether Trust1 and Trust2 are eligible to be treated as an ESBT and a QSST, respectively.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/s/

Christine Ellison  
Chief, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

A copy of this letter  
A copy for § 6110 purposes

cc: